North American Outlook

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A look ahead at the Canadian and American economies
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Sunny With Fog Patches

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KEY MESSAGES

- **Fiscal stimulus will add steam to the U.S. economy this year, but, along with tariffs, could propel inflation.**
- **Stronger U.S. demand will help Canada's economy slightly outrun its potential in the face of rising interest rates, restrictive housing policies and fading competitiveness.**
- **The Fed will outpace the Bank of Canada toward the policy exits, lifting rates each quarter this year.**
- **Protectionism and overheating are the two biggest threats to the North American expansion.**

Canada

- **The Canadian economy is running near potential**. Real GDP growth slowed to 1.3% in Q1 from 1.7% in each of the prior two quarters, a far cry from the average 4.3% pace in the first half of 2017. Temporary support from the oil price recovery, enhanced federal child benefits and Southern Ontario's housing boom has faded, while financial conditions have tightened. With the economy essentially at full employment, sustaining faster growth will require improvements in productivity and competitiveness.
- Following a 3.5% splurge in 2017, **consumer spending slowed to 1.1% in Q1 amid rising interest rates**. Household credit has rolled over, rising 4.9% y/y in April versus 5.9% last summer. After setting new speed records last year, auto sales have downshifted this year. Residential construction nosedived in the quarter, as sales were walloped by tougher mortgage rules (which pulled forward demand into late last year) and rising interest rates. Surprisingly, **business investment accelerated in Q1** after a strong 2017, as companies expanded capacity despite gnawing trade policy concerns.
- Stronger U.S. demand, higher oil prices and federal infrastructure spending should support an **improvement in GDP growth to 2.5% in Q2**. Non-resource export volumes have turned up after making little headway in the past decade, suggesting **net exports will add to growth for the first time in four quarters**. Manufacturing has also improved after a lengthy hibernation, with shipments up 6.4% y/y to March amid broad industry gains outside of autos.
- While growth is expected to slow to 2.0% in 2018, it should remain just above potential. This means the current 5.8% **jobless rate should slip to 5.5% by year-end, a level last seen in 1974**.
- **All provinces will downshift this year**. **Alberta** could see growth sliced to 2.2% this year from a province-leading 4.9% rate last year (albeit after two years in recession). This would allow **B.C.** to reassert itself as the nation's leader, benefitting from exports to fast-growing Asia. However, after four straight years of cruising above 3%, even B.C. will moderate to 2.4% amid a flurry of tax increases (corporate, personal, housing, carbon and payroll). Following the fastest pace (3.1%) in 17 years, **Quebec** is expected to moderate to 2.2% this year. Nonetheless, with companies ramping up investment amid tax relief, la Belle Province should once again top **Ontario** (2.0%), where business confidence has sagged. Given diverging plans for corporate

income taxes by the two leading parties in the polls, businesses will have a keen eye on the **June 7 election**.

- Rising interest rates, stricter mortgage rules and provincial policy measures have **corralled Vancouver's and Toronto's housing boom**. Detached home sales have fallen sharply in the past year to May, and Toronto prices are still down though stabilizing. The more affordable condo market remains piping hot in both cities, especially at the low end (studio and one bedroom). In the rest of the country, where all property types are affordable, activity remains healthy to April. The fastest population growth in a quarter century and prime-age-buying millennials are supporting demand. **Ottawa and Montreal are strengthening** amid healthy valuations and increased demand from non-resident investors. However, Alberta and Saskatchewan continue to struggle with elevated inventories, though this should not last long if oil prices continue to rise.
- The **Bank of Canada** has kept policy rates steady since January amid slower economic growth, trade policy risks and tougher mortgage rules. However, with the economy running near capacity, **the Bank signaled (at its May 30 announcement) that rates are likely to rise in July**. While elevated household debt warrants a go-slow approach to rate hikes, inaction can also heighten financial risks by encouraging more debt accumulation, according to Governor Poloz. We expect the current policy rate (1.25%) to reach the low end of the Bank's estimated neutral range (2.5%) in late 2019.
- Like the economy, the **Canadian dollar remains stuck in low gear.** After motoring above 81 cents (US) earlier this year, it has spun its wheels in the 76-to-79 cents range. That's close to "fair value" on a purchasing power basis for goods in the two countries, estimated by Statistics Canada at 77.5 cents (C$1.29). Record trade deficits, trade-policy uncertainty and a resurgent greenback have offset firmer oil prices (until recently) to hold down the currency. We see it trading **below 80 cents for most of the year.**

United States

- **The U.S. economy is poised to speed up this year.** While GDP slowed in the first quarter, the economy didn't weaken. Here's why: First, measured GDP almost always downshifts at the start of the year given quirky seasonal adjustment. Second, at 2.2%, growth still exceeded potential. Third, the slowing was mostly contained to two areas that posted big gains in Q4—consumer spending and residential construction. Fourth, business investment strengthened to a 9.2% rate, with gains spread across most industries.

- Firmer personal spending and industrial production in April, and an improved trade balance, **flag a much better second quarter**, though softer machinery orders indicate some moderation in capex. We recently **revised up our Q2 growth call to 3.2%** (from 2.8% previously) and see further upside potential.
- With **fiscal stimulus likely to add about 1% to GDP this year, growth should strengthen to 2.8%** from 2.3% last year. Although late-cycle imbalances are emerging, the current expansion is on track to surpass the decade-long stretch from 1991 to 2001 to become the longest on record (going back to the mid-1800s) by next summer. This should push the current **3.8% jobless rate** to a 48-year low of 3.5% by early next year.
- **The fiscal jolt has put a spring in the Fed's tightening step**. Policy rates are widely expected to rise on June 13, and we see further moves in each quarter until mid-2019. With core PCE inflation at 1.8% and the jobless rate headed lower still, the Fed has achieved its dual mandate. The focus for policy makers now should be on returning policy rates to neutral levels (closer to 3%) to prevent the economy from overheating.
- Rising trade policy risks and some slippage in oil prices have pulled the 10-year Treasury yield back below 3% after punching seven-year highs earlier on inflation concerns. Still, **we continue to look for year-end rates of 3.25% and 3.50% this year and next**.
- The **trade-weighted dollar's** 4% appreciation since mid-April has unwound most of its losses in the past year. Although rising trade and budget deficits will ultimately restrain the dollar, the risks skew to the upside given that many other central banks (notably the ECB, BoE and BoJ) are reluctant to tighten policies. Meantime, fiscal stimulus and firmer inflation warrant a more deliberate Fed response.

Risks

- The recent breakdown in NAFTA talks and removal of tariff exemptions on Canadian and Mexican steel and aluminum suggest a **NAFTA agreement is unlikely to be completed this year**, implying ongoing uncertainty for North American businesses. If talks fail, the consequences could range from the status quo (should Congress veto a repeal), to a so-called Zombie NAFTA (that's held up in the courts for years), to an outright termination. In the event that NAFTA is repealed, the outcomes range from just modestly weaker growth if governments abide by WTO trade rules, to a recession in Canada and Mexico and weak U.S. growth if they resort to more punitive protectionism. President Trump's musings about a **25% tariff on**

automotive products could devastate the Canadian and Mexican industries, with sizeable knock-on effects to both economies.

- U.S. business surveys cite growing concern about rising material costs and supply chain disruptions due to **import tariffs on steel and aluminum** and the U.S.-China tariff tiff. While the duties proposed to-date are insufficient to materially harm either economy, several rounds of retaliatory action could quickly escalate the damage.
- Taut labour markets, trade protectionism and loose fiscal policies imply upside **risks to inflation and interest rates**, the usual cause of past recessions.
- Although **oil prices** have retreated on speculation that Russia and the OPEC nations will increase production at the June 22-23 meeting, they could resume higher amid firm global demand and U.S. sanctions on Iran. This would raise inflation risks and weaken the U.S. expansion. Historically, a 10% increase in oil prices has tended to slow U.S. growth by almost 0.1 ppt. The 50 cents run-up in gasoline prices in the past year could shave 0.2 ppts from GDP growth this year, offsetting about half of the lift from tax cuts.
- With the **U.S. budget deficit** nearing $1 trillion next year (about 5% of GDP), the government will have less fiscal room to cushion the next downturn without avoiding a credit-rating downgrade.
- **Brexit uncertainty** has undermined U.K. growth and could slow the European economy. Pro- and anti-Brexit forces within the U.K. parliament are debating whether to pull the region out of the EU customs union. This issue will largely determine whether the U.K. faces a “soft” or “hard” Brexit.
- In **Italy**, a coalition government of two populist parties with plans to expand fiscal policy via tax cuts and spending increases has raised concerns about the nation’s already-high public debt (130% of GDP).
- On a more positive note, North and South **Korea** have agreed to a denuclearization deal, and the planned June 12 meeting between President Trump and North Korea’s Kim Jong Un appears to be on.

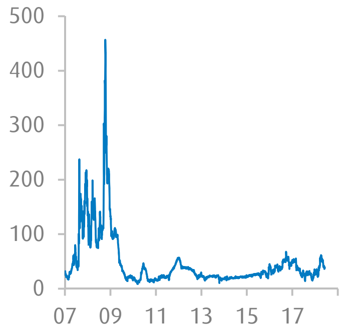
Forecasts

CANADA	2017 I	II	III	IV	2018 I	II	III	IV	ANNUAL 2017	2018	2019
Real GDP (q/q % chng : a.r.)	4.0	4.6	1.7	1.7	1.3	2.5	2.1	1.9	3.0	2.0	1.8
Consumer Spending	4.0	4.3	3.1	2.2	1.1	1.8	2.0	1.8	3.5	2.0	1.8
Business Investment (non-residential)	14.3	7.5	5.9	8.0	10.9	3.4	2.4	2.4	2.8	6.5	2.4
Consumer Price Index (y/y % chng)	1.9	1.3	1.4	1.8	2.1	2.4	2.5	2.3	1.6	2.3	2.1
Unemployment Rate (%)	6.6	6.5	6.2	6.0	5.8	5.8	5.6	5.5	6.3	5.7	5.5
Housing Starts (000s : a.r.)	222	207	223	229	224	218	220	218	220	220	210
Current Account Balance ($blns : a.r.)	-55.9	-59.6	-71.7	-65.9	-78.0	-68.9	-67.2	-65.8	-63.3	-70.0	-65.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.50	0.50	0.83	1.00	1.25	1.25	1.50	1.75	0.71	1.44	2.31
3-month Treasury Bill	0.47	0.54	0.81	0.92	1.14	1.25	1.50	1.70	0.69	1.40	2.20
10-year Bond	1.71	1.51	1.95	1.96	2.24	2.35	2.50	2.65	1.78	2.45	2.90
Canada/U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	-13	-37	-25	-30	-44	-66	-61	-54	-26	-56	-35
10-year	-73	-75	-30	-41	-52	-60	-58	-55	-55	-57	-48
UNITED STATES											
Real GDP (q/q % chng : a.r.)	1.2	3.1	3.2	2.9	2.2	3.2	2.9	2.9	2.3	2.8	2.5
Consumer Spending	1.9	3.3	2.2	4.0	1.0	3.5	2.5	2.2	2.8	2.6	2.2
Business Investment (non-residential)	7.1	6.7	4.7	6.8	9.2	1.9	2.8	2.4	4.7	5.4	2.3
Consumer Price Index (y/y % chng)	2.6	1.9	2.0	2.1	2.3	2.7	2.8	2.6	2.1	2.6	2.2
Unemployment Rate (%)	4.6	4.3	4.3	4.1	4.1	3.8	3.7	3.6	4.4	3.8	3.5
Housing Starts (mlns : a.r.)	1.23	1.17	1.17	1.26	1.32	1.29	1.30	1.28	1.21	1.30	1.28
Current Account Balance ($blns : a.r.)	-451	-495	-406	-513	-546	-553	-573	-588	-466	-565	-620
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.71	0.96	1.13	1.21	1.46	1.71	1.96	2.21	1.00	1.83	2.73
3-month Treasury Bill	0.60	0.90	1.06	1.23	1.58	1.90	2.10	2.25	0.95	1.95	2.55
10-year Note	2.44	2.26	2.24	2.37	2.76	2.95	3.05	3.20	2.33	3.00	3.40
EXCHANGE RATES (average for the quarter)											
US¢/C$	75.6	74.4	79.9	78.6	79.1	78.0	78.6	79.6	77.1	78.8	81.1
C$/US$	1.323	1.345	1.253	1.272	1.265	1.281	1.272	1.256	1.298	1.268	1.234
¥/US$	114	111	111	113	108	109	108	106	112	108	104
US$/Euro	1.07	1.10	1.18	1.18	1.23	1.19	1.18	1.23	1.13	1.21	1.27
US$/£	1.24	1.28	1.31	1.33	1.39	1.36	1.37	1.42	1.29	1.38	1.45

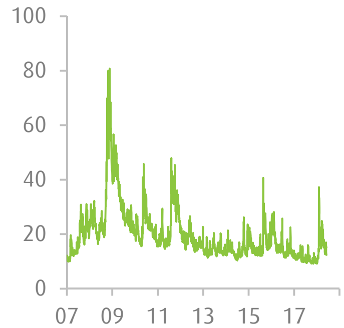
Note: Shaded areas represent BMO Capital Markets forecasts

VOLATILITY RECEDES
United States (as of June 5, 2018)

Ted Spread[1]



VIX[2]



[1] 3-mnth Eurodollar minus 3-mnth T-bills (bps) [2] CBOE market volatility index

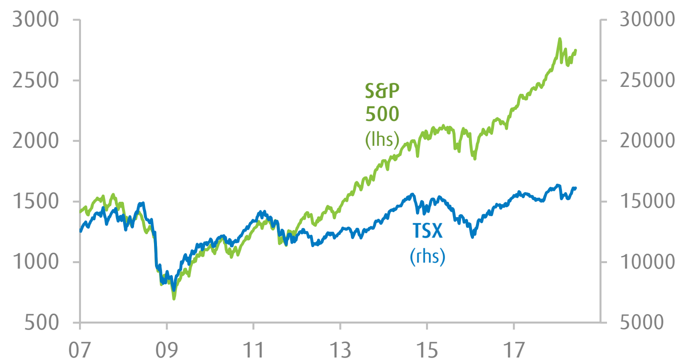
CREDIT SPREADS LOW
United States (ppts)

Corporate Bond Spreads[1]

[1] 15-year BoA Merrill Lynch AA Corporate Yield less 10-year Treasury Yield

EQUITIES STABILIZE
(indices : as of June 5, 2018)

Equities

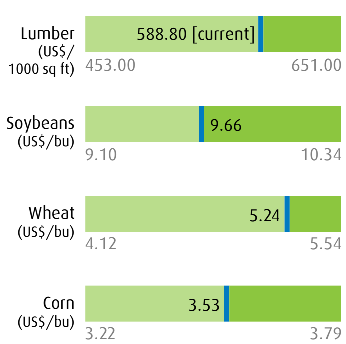


LOONIE NEAR FAIR VALUE
(US¢ : as of June 6, 2018)

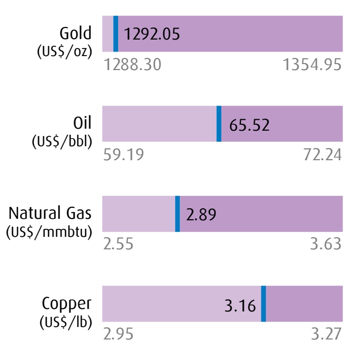
Canadian Dollar

GOLD LOSES GLITTER
Commodity price range since start of 2018

Materials & Foodstuffs
(as of June 5, 2018)



Metals & Energy
(as of June 5, 2018)



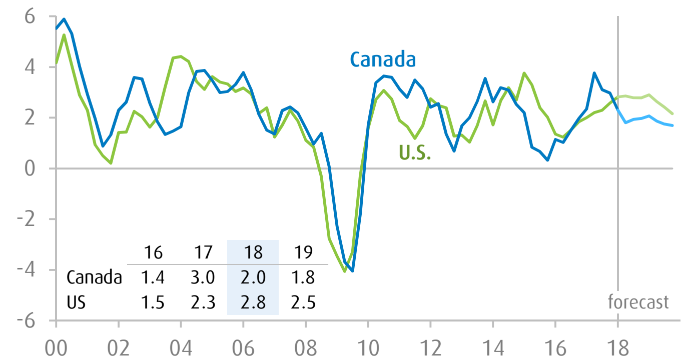
OIL PRICES RETREAT FROM 4-YEAR HIGHS
(US$/bbl : as of June 6, 2018)

WTI Crude Oil

...Russia and Saudi Arabia eye output increase

US ECONOMY GETS FISCAL JOLT
(y/y % change)

Real GDP

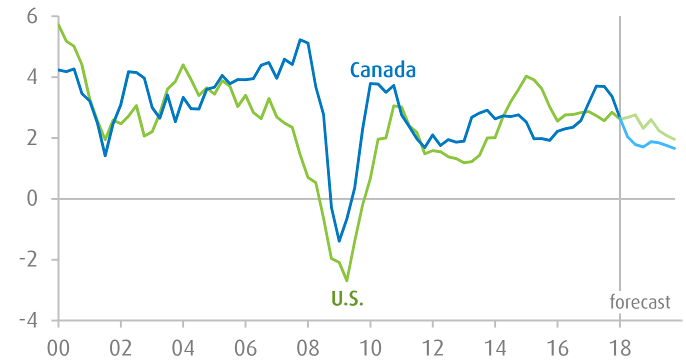


	16	17	18	19
Canada	1.4	3.0	2.0	1.8
US	1.5	2.3	2.8	2.5

Canadian growth moderates

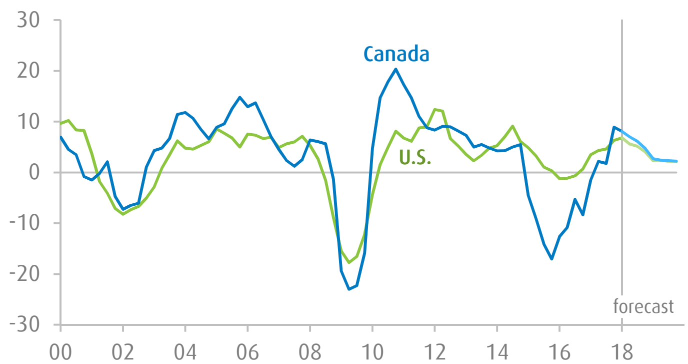
CANADIAN CONSUMERS TO DOWNSHIFT
(y/y % change)

Real Personal Consumption Expenditures



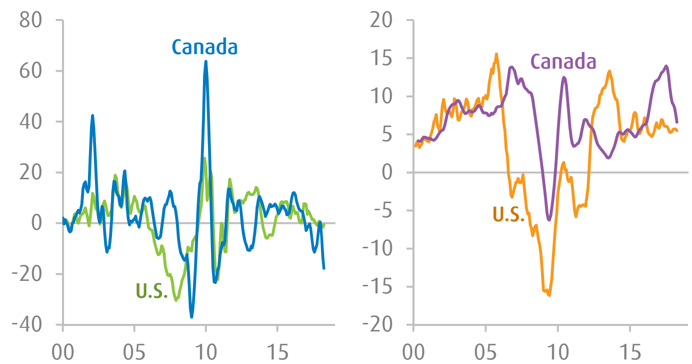
US BUSINESS INVESTMENT SOLID
(y/y % change)

Real Non-Residential Business Investment



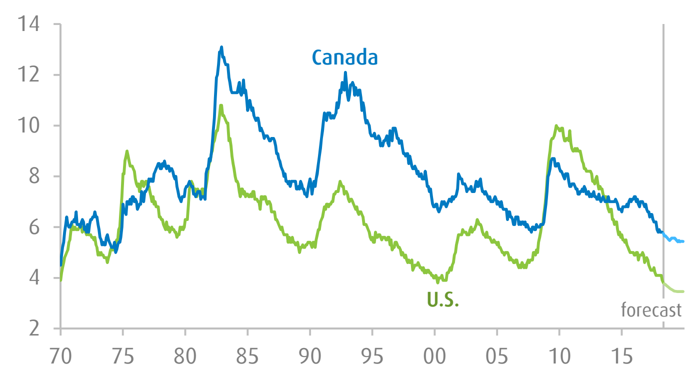
CANADIAN HOUSING MARKET SLOWS
Existing Homes (y/y % change : 3-month m.a.)

Sales Prices



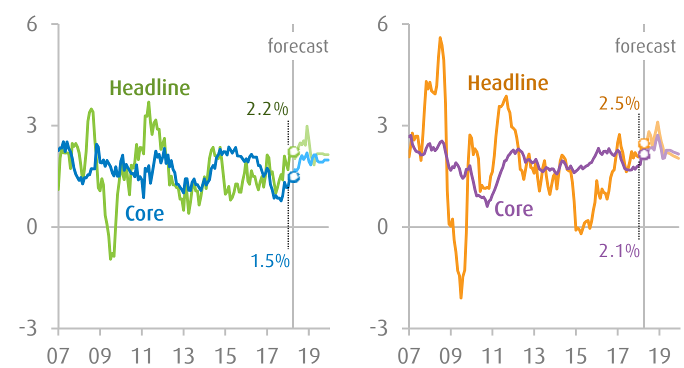
FULLY EMPLOYED
(percent)

Unemployment Rate

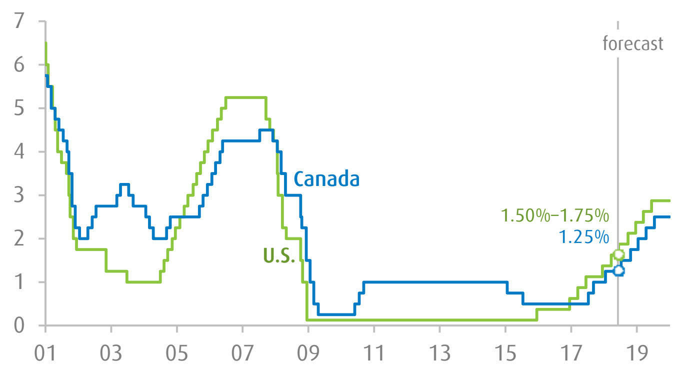


INFLATION PERKS UP
Consumer Price Index (y/y % change)

Canada United States



MONETARY POLICY TIGHTENS
(% : as of June 6, 2018)



LONG-TERM RATES RISE
(% : as of June 6, 2018)

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